

**The Law and Economics of FDI**  
30 hours

Course Convenors:

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## Course aims

The course addresses key issues in the law, economics and institutional dimensions of international investment activity and of ongoing efforts at regulating such activity. The main objective is to enable students to discover how legal issues and economic issues are interrelated as determinants of Foreign Direct Investment (FDI) which influence the location and investment decisions of Multinational Enterprises (MNEs) and ultimately their effects on home and host countries, although these latter aspects are not the subject of the course. This way, students will be able to “uncover” misconceptions about Foreign Direct Investment / Multinational Enterprises / International Investment Law and thus understand better some of the driving forces of globalization.

How is Foreign Direct Investment shaped by International Investment Law (i.e. the legal environment) is a central question in this course. We will examine the substantive law governing international investment, the enforcement of rights and obligations in investment disputes and the proper role of investment law in the international legal system. To answer these questions, the course tackles a number of theoretical, policy and legal issues stemming from the increasing importance of cross-border investment activity, situates key actors (the multinational enterprise, home and host country governments), and discusses the incipient and still very disparate nature of investment regulation, particularly at the global level. This type of knowledge is essential to decision makers in firms and the policy arena alike. Besides economic factors, corporate investment decisions depend on the legal framework governing international capital flows as well as on proactive policy measures which influence the locational quality. Further, such knowledge helps a lot in making sense of the debate on the relationship of MNEs and National Governments!

## Course units

Law Part	Economics Part
<p>A. Architecture and Dynamics of International Investment Law (2 units)  <i>Contents: Overview, bilateral investment treaties, preferential trade agreements, multilateral, recent patterns and innovations</i></p>	<p>A. Overview on Determinants of FDI (1 unit)  <i>Contents: Four groups of determinants; definition and types of FDI.</i></p>
<p>B. Principles of International Investment Law and Treaty Interpretation (2 units)  <i>Contents: Scope of IIAs, investor and investment, admission, right of establishment, standards of treatment, expropriation, does the system work?</i></p>	<p>B. Interpreting regression results (2 units)  <i>Contents: Interpreting regression results, size of coefficients, statistical (in)significance; measurement of variables; logarithm and elasticity; exercises and problems</i></p>
<p>C. Dispute Settlement (2 units)  <i>Contents: Legal aspects of arbitration, policy aspects, how to spot a BIT claim, structuring transactions in order to take advantage of IIAs, general conclusion</i></p>	<p>C. Empirical Evidence on “FDI Treaties” (FTAs, DTT and BITs) (3 units)  <i>Contents: Theoretical expectations; interpreting empirical results of selected studies; summary and open questions</i></p>

## Introduction to the law part

### Detailed description

The recent development of international investment protection law is remarkable and international Investment Law is emerging as a distinct and important field of international law. As countries increasingly opened their doors to FDI in the 1980s and 1990s, they simultaneously entered into numerous international investment agreements, leading especially to an explosion in the number of investment treaties. BITs are spreading at a breathtaking pace and they bind the contracting parties' governments toward foreign investors who may bring suit in international arbitration tribunals in case of any violation of the rules of the respective treaty. Such arbitrated cases raise important questions about the rights and obligations of international investors and the appropriate mechanisms for resolving investment disputes. Arbitration proceedings have alleged treaty violations in response to a range of state measures, including, for instance, emergency laws enacted during a financial crisis and the re-zoning of land for specific uses, and in a broad range of sectors such as construction, water and sewage services, telecommunications, financial services, mining, gas and oil production. Even more importantly, governments will, in the case of defeat, normally comply with an adverse arbitral award. Throughout the course, students are invited to reflect on the economic activity of foreign direct investment in its political and social context.

- Emphasis is also placed on assessing the effectiveness and legitimacy of public/private and hard/soft law forms of investment regulation.
- This course provides an overview of the principal substantive and procedural provisions of BITs. The substantive rights typically include a guarantee of prompt, adequate, and effective compensation for expropriation, freedom from unreasonable or discriminatory measures, a promise of "fair and equitable treatment" for foreign investments, guaranteed national and most-favored-nation treatment for investments, and assured full protection and security of investments. Together, these provisions are meant to boost investor confidence and the transparency of the policy environment.

### Bibliography

#### Core text:

- R. Dolzer & C. Schreuer (2008) *Principles of International Investment Law*, Oxford University Press.

#### Other books and articles

##### Unit A:

- J. Alvarez & K. Khamsi (2009) *The Argentine Crisis and Foreign Investors: A Glimpse into the Heart of the Investment Regime*, Yearbook of International Investment Law & Policy, No. 1.
- J. Chaisse & P. Gugler & (2008) *Foreign Investment Issues and WTO*, in: J. Chaisse & T. Balmelli, *Essays on the Future of the WTO*, (Geneva: Edis, 2008) 135-171.
- J. Salacuse (2007) *The Treatification of International Investment Law*, 13 Law and Business Review of the Americas 155-66.

##### Unit B:

- M. Reisman & R. Sloane (2003) *Indirect Expropriation and Its Valuation in the BIT Generation*, British Yearbook of International Law, No. 74, p. 115.
- OECD (2008) *International Investment Law: Understanding Concepts and Tracking Innovations: A Companion Volume to International Investment Perspectives* (Paris: OECD) 340.
- K. Sauvart (2009) *FDI Protectionism Is on the Rise*, World Bank Policy Research Working Paper (20p.).
- UNCTAD (2007) *International Investment Rule Making: stocktaking, challenges and the way forward* (Geneva: UNCTAD) 126.

### Unit C:

- G. Laborde (2010) *The Case for Host State Claims in Investment Arbitration*, Journal of International Dispute Settlement, Vol. 1 No.1, pp. 97-122.
- Todd Weiler (Ed), *International investment law and arbitration: leading cases from the ICSID, NAFTA, bilateral treaties and customary international law* London (London: Cameron May, 2005) 850.

#### Investment disputes:

- (national treatment) *Occidental Exploration v. Ecuador*, LCIA Case. No. UN 3467 (Final Award) (1 July 2004) paragraphs 1-6, 25-35 (facts), 167-179.
- (FET) *International Thunderbird Gaming Corp. v. United Mexican States*, UNCTRAL (Final Award) (26 Jan. 2006) paragraphs 41-84 (facts); 192-200.
- (host state sovereignty and transparency) *Metalclad Corp. v. Mexico*, ICSID Case No. ARB(AF)/97/1 (Award) (Aug. 30, 2000) paragraphs 28-63; 70-101
- (expropriation) *CMS Gas v. Argentina*, ICSID Case No. ARB/01/8 (Award) (12 May 2005), paragraphs 53-82 (facts) ; 252-265.
- (MFN) *Maffezini v. Spain* (ICSID Case No. ARB/97/7), (Decision of the Tribunal on Objections to Jurisdiction) (25 January 2000), pages 14-25.
- (MFN) *RosInvestCo UK v. Russian Federation*, SCC Case No. Arb. V079/2005, (Decision on Jurisdiction) (October 2007) paragraphs 124-139.
- (investments contracts) *SGS Société Générale de Surveillance S.A. v. Philippines*, Case No. ARB/02/6 (Decision on Jurisdiction (29 January 2004), paragraphs 92-97; 113-135.

### Questions

**Students are expected to come prepared and able to answer the following basic questions:**

**Unit A:** What rules of international law seem to you the most important to regulate FDI? How do FTA address investment issues? It is striking that treaty regimes establishing significant protections for direct foreign investment are almost exclusively the result of bilateral negotiations. The WTO has encountered great difficulty in clarifying and expressing general rules in this area. How would describe the relation of WTO with investment matters? Why is there no multilateral agreement (in the WTO or OECD) on investment? Why did previous attempts fail? Would you agree that the reason for this may be the enhanced power of capital-exporting party in the negotiation of a bilateral treaty and the enhanced power of a large number of capital-importing states in multilateral *fora*? What is the role of the Multilateral Investment Guarantee Agency (MIGA)?

**Unit B:** What are the main features of the United States BIT model? How does it differ of other models? What is a nationalization? What are measures “tantamount to” expropriation? What is the effect of an expropriation that does not meet the conditions of an investment treaty? What is the origin of the national treatment standard? Must a government have a protectionist motive in order to find a violation of the national treatment standard? What rationale did the *Maffezini* Tribunal use to determine that the most favored nations clause applied to dispute settlement procedure? What are the limits in applying most favored nations clauses to dispute settlement procedures? What is the minimum standard of international law? Is FET equivalent to the minimum standard of international law?

**Unit C:** What is the essential character of the system of investment arbitration? Does the system of investment arbitration pose a fundamental challenge to the principle of judicial independence? Can the arbitrators award an amount of compensation greater than a party’s claim? Do investors have the right to obtain specific performance/restitution in kind or can they only obtain compensation?

## An introduction to the seminar economics part

### Detailed description

Bilateral Investment Treaties (BITs) are usually thought to provide an important instrument for the attraction of Foreign Direct Investment (FDI). Besides BITs, other treaties like International Tax Treaties (ITTs) and Free Trade Agreements (FTAs) should be conducive to FDI. While there are good reasons to assume that this is indeed the case conceptually, it remains an empirical question whether this can be confirmed and whether the hypothesized effects are of a significant magnitude – not least since the number of BITs proliferated in the past decade. To answer these questions, we will first discuss determinants of FDI conceptually / theoretically. Turning to empirical studies, we will discuss the measurement and empirical evidence, including confirming as well as contradicting evidence, on determinants of Foreign Direct Investment as far as they relate to treaties, which are relevant for FDI. Why knowing the determinants of FDI is important: From a firm's point of view, location choice is based on compromises between different sets of determinants of FDI (or location factors). From a government's point of view, any policy measures related to FDI need to be evaluated as to their potential impact on FDI. To this end, policy trade-offs need to be understood. A precondition for both, firms and governments alike, is knowledge about the economic and statistical importance of single location factors as determinants of FDI.

#### Overview of determinants of FDI

*Market:* Market size and market growth; market potential; etc.

*Efficiency:* Labour costs (not only vertical FDI, but also horizontal FDI), (labour) productivity or total factor productivity; skill; infrastructure; transport costs / distance / trade costs; etc.

#### *Policy and Institutional Factors*

- Legal environment, judicial system, International Investment Law in particular;
- Infrastructure: tangible (roads; electricity supply;) / intangible (education) / social infrastructure (governance, education etc.);
- Taxes / Thin cap rules etc.
- R&D subsidies;
- Special Economic Zones / Special Enterprise Zones / industrial clusters / agglomerations;
- Specific incentives (or targeted policies); removing specific regulatory obstacles to inward FDI; restrictions on FDI; enhancing product market competition;
- Trade barriers / capital liberalization / economic integration;
- Democratization, human rights, left-right government;
- Environmental regulations;
- Ease of doing business; corruption; economic freedom; risk, inflation; privatization;
- Labour market parameters: union bargaining power, employment protection legislation; core labour standards etc.

### Bibliography

#### **Core Texts:**

Please note: all participants are required to study the key references prior to the course.

BARBA-NAVARETTI, G. and A.J. VENABLES Chapter 6 on "Determinants of FDI: the Evidence", in: *Multinational Firms in the World Economy* 2004, pp. 127-150.

BALDWIN, R.E. (2005) Industry location: The causes, *Swedish Economic Policy Review*, 12, pp. 9-27.

#### **Other books and articles:**

##### **Unit A:**

PENROSE E. (1998) Multinational corporations. In: *The new Palgrave. A dictionary of economics.* Eatwell J., Mulgat M., Newman P. (eds), Macmillan, pp. 562-564

OECD (2008) Benchmark Definition of FDI, 4<sup>th</sup> Ed.

**Unit B:**

WOOLDRIDGE, J. (2001) Introductory Economics, A modern approach (Ch. 1, Ch. 4, Appendix A, Appendix C.6).

**Unit C: Empirical Studies**

(Note: These empirical papers are **not** part of the reader. Tables included in these empirical papers appear on the slides and will be used during teaching to discuss empirical results.) For interpretations of results tables in empirical studies, the following Link is useful. This page shows an example regression analysis with footnotes explaining the output:

[http://www.ats.ucla.edu/stat/stata/output/reg\\_output.htm](http://www.ats.ucla.edu/stat/stata/output/reg_output.htm)

• *Market*

HEAD K., MAYER T. (2004) Market potential and the location of Japanese investment in the European Union. *The Review of Economics and Statistics*, Vol. 86, No. 4, pp. 959-972

YAMAWAKI H. (2004) The determinants of geographic configuration of value chain activities: foreign multinational enterprises in Japanese manufacturing. *International Economics and Economic Policy*, Vol. 1, pp. 195-213

• *Efficiency*

BELLAK, C. with M. LEIBRECHT and A. RIEDL, Labour costs and FDI flows to the CEECs: A Survey of the Literature and Some empirical Evidence, *Economic Dynamics and Structural Change*, 19, March 2008, pp. 17-37.

NEARY J.P. (2006) Trade costs and foreign direct investment. *CEPR Discussion paper series*, No. 5933, pp. 1-19

• *Policy Factors*

BELLAK, C. with M. LEIBRECHT and J. DAMIJAN Infrastructure endowment and corporate income taxes as determinants of Foreign Direct Investment in Central- and Eastern European Countries, *The World Economy*, Vol. 32, Issue 2, February 2009, pp. 267 - 290.

DE SANTIS R.A., STÄHLER F. (2008) Foreign direct investment and environmental taxes. *German Economic Review*, Vol. 10, No. 1, pp. 115-135

DEMOOIJ, R. and S. EDERVEEN Corporate Tax Elasticities A reader's guide to empirical findings, *Oxford Economic Policy*, 2009

PETROULAS P. (2007) The effect of the euro on foreign direct investment. *European Economic Review*, Vol. 51, pp. 1468-1491

• *Institutional Factors*

*Domestic*

BENASSY-QUERE, A., M. COUPET AND TH. MAYER: Institutional Determinants of Foreign Direct Investment, 2007, *The World Economy*.

BUSSE, M. AND C. HEFEKER (2007) Political risk, institutions and foreign direct investment, *European Journal of Political Economy*, 23, 2007, pp. 397-415.

JAVORCIK B.S., SPATAREANU M. (2004) Do foreign investors care about labor market regulations? *World Bank Policy Research Working Paper*, No. 3275, pp. 1-25

*BITs*

AISBETT, E. (2009) Bilateral Investment Treaties and Foreign Direct Investment: Correlation Versus Causation, In: SAUVANT K. P. and SACHS L. E., *The Effect of Treaties on Foreign Direct Investment. Bilateral Investment Treaties, Double Taxation Treaties, and Investment Flows*, pp.395 – 435.

BÜTHE, T. and MILNER H. V. (2004) Bilateral Investment Treaties and Foreign Direct Investment: A Political Analysis, Annual Meeting of the American Political Science Association (APSA), Chicago, September 2004, In: SAUVANT K. P. and SACHS L. E., *The Effect of Treaties on Foreign Direct Investment. Bilateral Investment Treaties, Double Taxation Treaties, and Investment Flows*, pp.171 – 224.

EGGER, P. and PFAFFERMAYR, M. (2004) The impact of bilateral investment treaties on foreign direct investment, *Journal of Comparative Economics*, Vol. 32, Nr. 4, pp. 788 – 804.

EGGER, P. and V. MERLO (2007) The Impact of Bilateral Investment Treaties on FDI Dynamics, *The World Economy*, 1536-1549.

- GALLAGHER, K. P. and BIRCH, M. B. L. (2006) Do investment agreements attract investment? – evidence from Latin America, *Journal of World Investment and Trade*, Vol. 7, No. 6, pp. 961 – 974.
- HALLWARD-DRIEMEIER, M. (2003) Do Bilateral Investment Treaties Attract FDI? Only a Bit ... And They Could Bite, *World Bank Policy Research Working Paper*, No. 3121, 1- 37.
- NEUMAYER, E. and SPESS, L. (2005) Do bilateral investment treaties increase foreign direct investment to developing countries? *World Development*, Vol. 33, No. 10, pp. 1567 – 1585.
- ROSE-ACKERMANN, S. (2009) The Global BITs Regime and the Domestic Environment for Investment, In: SAUVANT K. P. and SACHS L. E., *The Effect of Treaties on Foreign Direct Investment. Bilateral Investment Treaties, Double Taxation Treaties, and Investment Flows*, pp. 311 – 322.
- SALACUSE, J. W. and SULLIVAN, N. P. (2005) Do BITs really work: an evaluation of bilateral investment treaties and their grand bargain, *Harvard International Law Journal*, Vol. 46, No. 1, pp. 67 – 130.
- SWENSON, D. L. (2005) Why Do Developing Countries Sign BITs? *U.C. Davis Journal of International Law & Policy*, Vol. 12, No. 1, pp. 131 – 155.
- UNCTAD (1998) *Bilateral Investment Treaties in the Mid-1990s*, UNCTAD, chapter IV, New York and Geneva: United Nations.
- YACKEE, J. (2009) Do BITs Really Work? Revisiting the Empirical Link Between Investment Treaties and Foreign Direct Investment. In: SAUVANT K. P. and SACHS L. E., *The Effect of Treaties on Foreign Direct Investment. Bilateral Investment Treaties, Double Taxation Treaties, and Investment Flows*, pp.379 – 394.

#### *DTTs*

- BARTHEL, F., M. BUSSE and E. NEUMAYER (2009) *The Impact of Double Taxation Treaties on Foreign Direct Investment: Evidence from Large Dyadic Panel Data*, Revised Version, May, mimeo.
- BLONIGEN, B. A., DAVIES, R. B. (2004) The effects of bilateral tax treaties on U.S. FDI activity, *International Tax and Public Finance*, Vol. 11, No. 5., pp. 601-622.
- BLONIGEN, B. A. and DAVIES, R. B. (2005) Do Bilateral Tax Treaties Promote Foreign Direct Investment? In: Hartigan J. , ed., *Handbook of International Trade, Volume II: Economics and Legal Analysis of Laws and Institutions*, Oxford, U.K. and Cambridge, MA: Blackwell Publishers, 2005.
- CHRISTIANS, A. (2005) *Tax Treaties for Investment and Aid to Sub-Saharan Africa*, *Brooklyn Law Review*, No. 71, pp. 639-700.
- DAVIES, R.B., P.J. NORBAECK and A. TEKIN-KURU (2009) The Effect of Tax Treaties on Multinational Firms: New Evidence from Microdata, *The World Economy*, pp. 77-110, Table 4.
- EGGER, P., LARCH M., PFAFFERMAYR, M. and WINNER, H. (2006) The impact of endogenous tax treaties on foreign direct investment: theory and empirical evidence, *Canadian Journal of Economics*, Vol. 39, No. 3, pp. 901-931.
- LOUIE, H. J., and ROUSSLANG, D. J. (2008) Host-country governance, tax treaties, and American direct investment abroad, *International Tax and Public Finance*, Vol. 15, No. 3, pp. 256 – 273.
- MILLIMET, D. L. (2009) It's all in the timing: Assessing the Impact of Bilateral Tax Treaties on U.S. FDI Activity, In: SAUVANT K. P. and SACHS L. E., *The Effect of Treaties on Foreign Direct Investment. Bilateral Investment Treaties, Double Taxation Treaties, and Investment Flows*, pp. 635 – 657.
- NEUMAYER, E. (2007) Do Double Taxation Treaties Increase Foreign Direct Investment to Developing Countries? *Journal of Development Studies*, Vol. 43, No. 8, pp. 1501-1519, November.

#### *FTAs*

- BALASUBRAMANYAM, V.N., and D. GREENAWAY “Regional Integration Agreements and Foreign Direct Investment,” in *Regional Integration and the Global Trading System*, Kym Anderson and Richard Blackhurst, eds., New York: St. Martin's Press, 1993.
- BALTAGI, B.H. & EGGER, P. & PFAFFERMAYR, M. (2008) Estimating regional trade agreement effects on FDI in an interdependent world, *Journal of Econometrics*, Elsevier, vol. 145(1-2), pages 194-208.

BLOMSTRÖM, MAGNUS, AND ARI KOKKO. "Regional Integration and Foreign Direct Investment," National Bureau of Economic Research Working Paper No. 6019, April, 1997.

DONNENFELD, S. (2003). Regional blocs and foreign direct investment. *Review of International Economics*, 11, 770-788.

JAUMOTTE, Florence Foreign Direct Investment and Regional Trade Agreements: The Market Size Effect Revisited, IMF Working Paper, 04/206.

MACDERMOTT, R. (2006). Regional trade agreements and foreign direct investment. *The North American Journal of Economics and Finance*, 18, 107-116.

MOTTA, Massimo, and George NORMAN. "Does Economic Integration Cause Foreign Direct Investment?" *International Economic Review* 37(4), November 1996, pp. 757-783.

PONCE, Aldo Fernando (2006) Openness and Foreign Direct Investment: The Role of Free Trade Agreements in Latin America. Unpublished.

## Questions

**Students are expected to come prepared and able to answer the following basic questions:**

**Unit A:** The determinants of FDI may be grouped into four groups: name at least three examples of important location factors included in each group. Explain, how these factors are related to FDI.

**Unit B:** Explain the concept of statistical significance / statistical insignificance means. Clarify the relationship between the natural logarithm and an elasticity. What is a variable? What is a coefficient? What is an elasticity? What is a semi-elasticity? Interpret the results in Table xxx in the study by xxxx.

**Unit C:** Describe the expected relationship of FDI and (a) BITs, (b) DTTs and (c) FTAs. Concerning BITs, describe in greater detail the range of results (Hint: Are the coefficients of different studies comparable? If not, how do they have to be transformed?) Taken these results together, how can these results be summarized, if you should answer the question how BITs affect FDI? How important are the effects of BITs compared to other location factors, DTTs in particular, which have been discussed in Unit A?

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## Assessment

Students are expected to attend all classes and to be punctual. Students are also expected to participate meaningfully to class discussion throughout the course. Moreover, to fully benefit this course students must:

- Read the materials and problems assigned for each class
- Be prepared to actively participate in each large and small group class
- Be willing to ask questions, raise issues and contribute to class discussions.

The grades for the course are based on three components:

- *Seminar Participation (10%)*: You will be awarded this mark for being prepared for each class and actively contributing in a positive way to the class discussions.
- *Case Presentation (30%)*: Students are encouraged to participate in classroom discussion and may choose to make a 15-20 minute **presentation/discussion** with the class on an arbitration case. Students are expected to complete some additional readings and research in order to prepare for the class. Students are encouraged to incorporate their research for the final assessment into the presentation and, in this regard, this assessment option will compliment and assist the research for the final exam. Please do not hesitate to contact us by phone, e-mail etc. if questions or problems turn up during the preparation of the cases. We would be happy to assist you.
- *Final Exam (60%)*: (Please note: The date for the final exam will be set during the course.)

## Exam questions examples

- Recent cases suggest that the MFN obligation extends to procedural rights as well as substantive rights. Is this a reasonable determination and what are the ramifications of such a determination?
- What economic effect does FDI have on the host country and on the investor? What strategies do investors and host countries pursue in the investment process?
- It is striking that treaty regimes establishing significant protections FDI are almost exclusively the result of bilateral negotiations. Would you agree that the reason for this may be the enhanced power of capital-exporting party in the negotiation of a bilateral treaty and the enhanced power of a large number of capital-importing states in multilateral *for a*?

## Specialized websites

They provide access to current investment treaty decisions, awards and other materials, including links to further resources:

- Digest of Investment Treaty Decisions and Awards: <http://arbitration-icca.org>
- ICSID: <http://icsid.worldbank.org>
- Investment Arbitration Reporter: <http://iareporter.com>
- Investment Claims: <http://investmentclaims.com>
- Investment Treaty Arbitration: <http://ita.law.uvic.ca>
- Investment Treaty News: <http://iisd.org/investment/itn>
- Kluwer Arbitration: <http://kluwerarbitration.com>
- NAFTA Claims: <http://naftaclaims.com>
- Transnational Dispute Management: <http://transnational-dispute management.com>>
- UNCTAD international investment agreement: <http://unctad.org>